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INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR Associate Area Counsel,
ATTN:

FROM: Associate Chief Counsel, Income Tax & Accounting

SUBJECT: Whether initial membership fees paid to a taxpayer by new members of private golf clubs constitute taxable gross receipts to the taxpayer.

This Chief Counsel Advice responds to your memorandum dated May 7, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

$a =

b =

c =

ISSUE

Whether initial membership fees paid to Taxpayer by new members of private golf courses, which are owned and operated by Taxpayer, constitute taxable gross receipts to Taxpayer.

CONCLUSION

The membership fees are in the nature of refundable deposits not includible in the income of the Taxpayer in the tax year of receipt.

FACTS

Taxpayer owns and manages public and private golf courses. Taxpayer collects a membership fee from each new member. The membership fee is a one-time flat fee that is paid in addition to the monthly fee and other dues. This flat fee can be as high as $a. Taxpayer has provided a membership contract that is representative of its contracts. The contract provides that, upon the club's receipt of the full amount of the initial membership fee and its approval of the membership application, the club promises to pay to the member the original principal amount of the fee in b years from the date of approval of the member's application. The contract also provides that this amount may be reduced, if necessary, by all amounts which may be due to the club from the member. The contract further states that the membership fee will not be refundable in whole or part if the membership is terminated by the club as a result of any violation of the club's rules and regulations. Under the terms of the contract, the member agrees that, if he or she voluntarily terminates membership prior to the b-year anniversary date, the club shall not be obligated to refund any part of the membership fee at any time prior to the b-year anniversary date. Further, the member is not entitled to the payment of any interest on the membership fee, and the club may prepay the membership fee at any time, in whole or in part, without penalty. The right to receive the repayment of the membership fee is not transferable or negotiable.

The contract further provides that, if the member leaves Taxpayer's club prior to the b-year anniversary date of that member's entry, none of the membership fee is refunded prior to this b-year anniversary date unless a new member replaces the resigning member. If a new member does replace the resigning member, the resigning member receives a refund at the time the new member is accepted equal to c% of the amount the new member pays as his or her initial membership fee. The amount of the resigning member's original membership fee is reduced by this amount, and the balance of the original membership fee is refunded to the resigning member on the b-year anniversary date of that member's entry into the club.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code defines gross income as all income from whatever source derived. Section 1.61-1(a) of the Income Tax Regulations provides that gross income includes income realized in any form, whether in money, property, or services. Gross income includes an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion. Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955).

A taxpayer generally does not have an accession to wealth, nor complete dominion over an item, when the item is received subject to an obligation to repay,

as with a refundable deposit or a loan. Commissioner v. Indianapolis Power & Light, 493 U.S. 203 (1990); Commissioner v. Tufts, 461 U.S. 300 (1983), 1983-1 C.B. 120. However, a financial arrangement that purportedly requires the repayment of an item might actually serve to compensate the recipient, in advance, for services and/or goods. The facts of each case must be carefully examined to determine whether an item received is a taxable advance payment even though the recipient has a purported obligation to repay.

In Indianapolis Power and Light, 493 U.S. at 203, customers with suspect credit paid deposits to the utility company in order to secure future payment of electric bills. Upon receipt of the deposit, an obligation was imposed on the utility company to refund the deposit once the customer either terminated service or proved its creditworthiness. Even though the money could eventually be used to pay for electricity by virtue of customer default or choice, the customer was not obligated to purchase any electricity at all at the time the deposits were paid. In considering the tax treatment of deposits, the Supreme Court stated:

> Whether these payments constitute income when received, however, depends on the parties' rights and obligations at the time the payments are made. * * * Whether these customer deposits are the economic equivalents of advance payments, and therefore taxable upon receipt, must be determined by examining the relationship between the parties at the time of the deposit. The individual who makes an advance payment retains no right to insist upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep. The customer who submits a deposit to the [taxpayer] * * * retains the right to insist upon repayment * * * and the [taxpayer] therefore acquires no unfettered "dominion" over the money at the time of receipt.

Id. at 211-212 (1990).

Thus, the taxpayer's unrestricted use of the funds is not dispositive. Id. at 209-210. Whether the taxpayer pays or accrues interest on the depositor's behalf is also not a controlling factor. "The key," wrote the Supreme Court in Indianapolis Power & Light Co., "is whether the taxpayer has some guarantee that he will be allowed to keep the money." Id. at 210. The Supreme Court ultimately held that the utility customers' deposits were not advance payments, since the customers were under no obligation to purchase goods or services, and the customers' behavior controlled the amounts of the refunds. Therefore, the customers' deposits were not taxable income to the utility.

Similarly, in Oak Industries, Inc. v. Commissioner, 96 T.C. 559 (1991), the Tax Court addressed certain deposits, which were intended as offsets to any

unpaid fees, damages to equipment, or any other costs to the taxpayer due to a customer's breach. The customer who performed according to his or her obligations had a right to a refund of the deposit. The court applied the standards set forth above in Indianapolis Power & Light Co. and concluded that these deposits were not taxable income to the taxpayer.

In Highland Farms, Inc. v. Commissioner,106 T.C. 237 (1996), the Tax Court concluded that the entire amount of entry fees received by an accrual-basis, continuing care retirement community from the residents of its apartments and lodge did not constitute prepaid rent or advance payment for services. Consequently, the entry fees did not require inclusion in gross income in the year of receipt. In Highland Farms, the petitioner's apartments were available in efficiency, one bedroom, or two bedroom units upon payment of an entry fee and monthly rent pursuant to a rental contract. Petitioner collected the entire entry fee before the resident moved into an apartment and no interest accrued on the entry fee. The monthly rent included the cost of utilities and emergency nursing services. The entry fees for the apartments during 1988 were as follows: $16,000 for an efficiency; $22,000 for a one bedroom; and $28,000 for a two bedroom. The rental contract did not specify the length of the agreement. Residents intending to terminate occupancy were required to give 120 days' notice and were obligated to pay the rent for that period even if they vacated the premises prior to the end of the 120-day period, unless a new tenant rented the unit within that time. Taxpayer had the right to evict an apartment resident on demand for failure to keep financial accounts current. If a resident was disruptive, created an undue hazard to himself or others, or failed to abide by the rules and regulations of petitioner, petitioner had the right to terminate the rental agreement. The agreement would terminate in the event of destruction of the building rendering the apartment uninhabitable, except the agreement would not terminate if taxpayer opted to repair the building and provide the resident with accommodations during the repair period.

According to the rental contract, the entry fee was deemed to have been earned by petitioner as follows: 10% at the time the tenant takes occupancy of the unit; 10% during the first year of occupancy, prorated on a monthly basis; 20% during each of the next four (4) years, prorated on a monthly basis. If a resident terminated the rental contract or died within the first 5 years, petitioner refunded to the resident or to the resident's estate the portion of the entry fee deemed unearned. However, petitioner was entitled to offset against this refund any amounts due under the terms of the agreement, such as health-care center charges. Similar terms were set forth regarding agreements for occupancy in the petitioner's lodge or health care unit.

The Tax Court applied the above principles from Indianapolis Power and Light to the facts of the case before it. The court noted that the residents of the apartments and the lodge, if they decided to move out of their units, had a right to a

refund of a portion of their entry fees in accordance with the schedules stated in their respective rental contracts. The refunds thus were within the residents' control, and petitioner had "no unfettered 'dominion' over the money at the time of receipt." At the time the entry fees were paid, the only amounts petitioner was guaranteed to be allowed to keep were the nonrefundable portions. Thus, the Tax Court held that the refundable portions were not advance payments for services or prepaid rent. As a result, petitioner was not required to include the entire amount of the entry fees in income in the year of receipt. Petitioner did include in income for a specific taxable year those portions of the entry fees for the apartments and the lodge that became nonrefundable or nonforfeitable within that tax year. The court specifically found that this method of accounting for the entry fees clearly reflects income.

Although decided prior to the above cases, two revenue rulings addressed fact situations similar to the present case. In Rev. Rul. 58-17, 1958-1 C.B. 11, a swimming club received membership fees from those who desired to join. Club members were also required to pay annual dues. The membership fees were refundable within five years after a stated date, unless a member became delinquent in the payment of annual dues in which case the club could retain the delinquent amount from the otherwise refundable fee. The revenue ruling concludes that the membership fees were in the nature of loans and excludable upon receipt from gross income because the club had a continuing obligation to refund the fees.

In Rev. Rul. 66-347, 1966-2 C.B. 196, a swimming club received membership fees, and its members were required to pay monthly dues. The membership fees were refundable only if a member moved out of the locality of the club within five years from joining. A member was entitled to a declining portion of the fee based upon the length of membership in the club, and after five years, members were not entitled to any refund. The ruling concludes that the membership fees received by the taxpayer are income for the taxable year in which received or accrued, depending on the taxpayer's method of accounting, even though the taxpayer subsequently may be required to refund a portion of such fees.

In Rev. Rul. 66-347, the taxpayer was obligated to refund a declining portion of the fees if a member moved away within the first five years. In the present case, Taxpayer's club has an obligation to refund the initial membership fee to a continuing member in b years if the fee has not been repaid at an earlier time. This obligation to refund is absolute and is not premised on the occurrence of a contingency. Because of the club's obligation to repay the membership fee, Taxpayer did not acquire unfettered "dominion" over the money at the time of receipt. In other words, at the time Taxpayer received an initial membership fee, it did not obtain some guarantee that it will be allowed to keep the money within the

meaning of Indianapolis Power and Light and Highland Farms.[1] Accordingly, we conclude that the membership fees are in the nature of refundable deposits and thus are not includible in the income of Taxpayer at the time of receipt.[2]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call if you have any further questions.

/s/
CHRISTOPHER F. KANE
Chief, Branch 3
Associate Chief Counsel
(Income Tax & Accounting)

[1] Although we noted that the facts in Rev. Rul. 66-347 are distinguishable from the facts here, we further note that the holding in that ruling may be questionable in light of the Tax Court's opinion in Highland Farms.

[2] Although we conclude that the initial membership fees are not includible in Taxpayer's income at the time of receipt, we note that such amounts will be includible in the income of Taxpayer at the point in time at which Taxpayer has unfettered dominion over the funds pursuant to the membership contract (e.g., at the time a member forfeits its membership fee due to violation of a club's rules), all events have occurred which fix Taxpayer's right to receive such income, and the amount can be determined with reasonable accuracy. See § 1.451-1(a).